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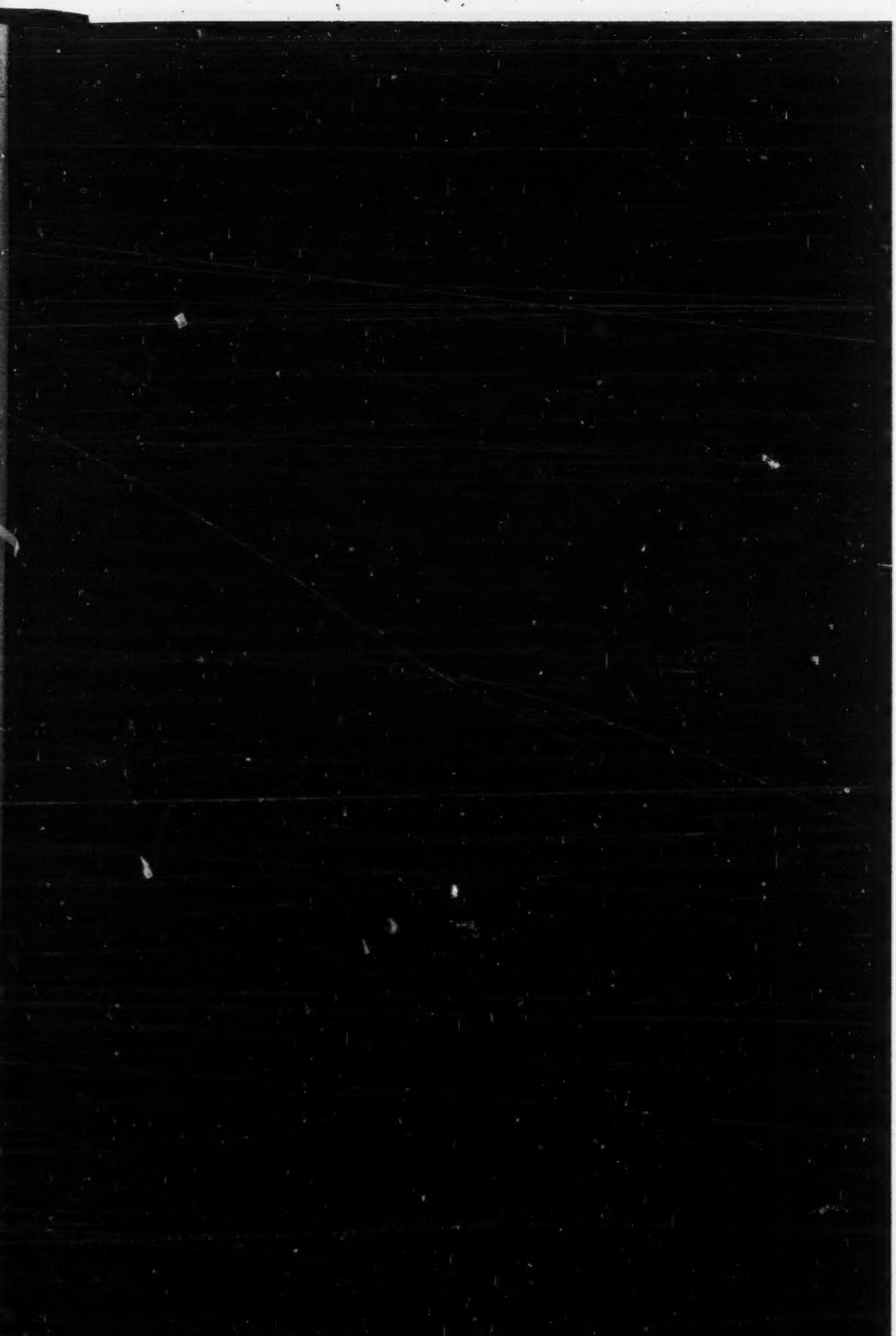

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IN THE

Supreme Court of the United States

October Term 1940
No. 601

PAUL W. SAMPSELL, as Trustee in Bankruptcy for the Estate of WILBUR J. DOWNEY, also known as W. J. Downey,

Petitioner,

vs.

IMPERIAL PAPER AND COLOR CORPORATION,

Respondent.

OPENING BRIEF OF PETITIONER.

This case comes to this court on Writ of Certiorari to the Ninth Circuit Court of Appeals, issued by this Court on January 13, 1941.

The petitioner as Trustee in Bankruptcy seeks to reverse an order of the United States Circuit Court of Appeals for the Ninth Circuit granting priority of payment of the claim of the Imperial Paper and Color corporation, against assets in his hands as Trustee in Bankruptcy, belonging to the bankrupt estate, which constitute the proceeds of a recovery made by the trustee against the Downey Wallpaper & Paint Co., a family corporation of Downey's, under the provisions of §70-e of the Bankruptcy Act of the United States (11 USCA, §110-e), as

property transferred by the bankrupt in fraud of his creditors, or the value thereof.

The Opinion of the Circuit Court of Appeals is entitled *Imperial Paper and Color Corporation v. Sampsell, Trustee,* 114 Fed. (2d) 49, and is set out in the Transcript of Record here at page 200.

The jurisdiction of the District Court was invoked originally under the provisions of §2, Subdv. (2) of the National Bankruptcy Act (11 USCA, §11, Subdv. (2)), and the jurisdiction to avoid the fraudulent transfer and to quiet title to the property was invoked in addition, under the provisions of §70-e of the National Bankruptcy Act. (11 USCA, §110-e.)

The jurisdiction of the Circuit Court of Appeals was invoked under the provisions of §24-a of the National Bankruptcy Act (11 USCA, §47-a.)

The jurisdiction of this court was invoked under the provisions of §24-c of the National Bankruptcy Act (11 USCA, §47-c) and §240 of the Judicial Code, 28 USCA, §347.

The Order of the trial court (Referee in Bankruptcy) was entered September 28, 1939. [Tr. p. 35.] The Order of the District Court affirming the Referee's Order on review was entered November 17, 1939. [Tr. p. 36.] The Order of the Circuit Court of Appeals was entered August 12, 1940. [Tr. p. 199.]

A petition for rehearing was filed and was denied by the Circuit Court of Appeals on September 7, 1940, whereupon this court granted certiorari.

Statement of Facts.

Wilbur J. Downey, the bankrupt, was a retail merchant dealing in wallpaper, paints, and other decorative materials, for several years prior to the filing of the petition in bankruptcy. His place of business was at 821 South Flower Street, Los Angeles, California. In July, 1936, and prior thereto, he had become seriously involved financially and was heavily indebted to the Standard Coated Products Corporation (formerly known as the Standard Textile Products Company) in the sum of approximately $108,000. The Standard Coated Products Corporation was and is a creditor in Downey's bankruptcy proceeding.

The sole asset which Downey possessed in July, 1936 and which could be utilized for the reduction or the liquidation of this indebtedness consisted of a stock in trade in his business which was valued at approximately $14,000. [Tr. p. 14.] With this heavy indebtedness outstanding, Downey went to Glenns Falls, New York, shortly prior to July 1, 1936, and conferred with the President of the Imperial Paper and Color Corporation with regard to his taking on the Imperial's line of merchandise. [Tr. p. 41.] The Imperial Paper and Color Corporation was informed of the enormous indebtedness which Downey owed to the Standard Coated Products Corporation, at the time of this conference. The President of the Imperial suggested to Downey that he do one of three things: Either form a corporation, go into bankruptcy, or persuade the Standard Coated Products Corporation to reduce the indebtedness which Downey owed to it to what the President characterized as "a decent figure". [Tr. p. 41.] After this suggestion was made to him by the President of the respondent herein,

Downey returned to Los Angeles and organized a family corporation known as the Downey Wallpaper & Paint Co. This corporation issued five shares of stock to Downey, and the greater portion of it was ultimately issued to his wife. [Tr. pp. 42, 43.] The original subscription was for $500.00 worth of stock, which was paid for in money. [Tr. p. 59.]

After this corporation was organized and the original stock issued, Downey proceeded to transfer practically his entire stock in trade, constituting his remaining asset, to this family corporation. The consideration for the transfer was a promissory note executed by the corporation, payable to himself, and covered the entire purchase price. [Tr. p. 42.]

On June 17, 1936, before the organization of Downey's family corporation was completed, Downey's attorney, Frank S. Hutton, wrote a letter to the Imperial Paper and Color Corporation, at whose instigation the family corporation was being created, and in that letter informed the respondent that the Downey Wallpaper & Paint Co. was being organized and that Downey was going to sell all his wallpaper and paints to his new corporation on six months' terms. In this letter he informed the Imperial people that Downey's proposed plan of reorganization had been "turned down by the Standard Coated Products Corporation", to whom he owed $108,000, and that by the time the Imperial people received Hutton's letter "we will be functioning full blast as the Downey Wallpaper & Paint Co." [See Trustee's Exhibit No. 1, Tr. pp. 50, 51.]

A week later, the respondent, Imperial Paper and Color Corporation, received another letter from Mr. Hutton

under date of June 24, 1936, which informed it of the further steps that were being taken by Downey in the perpetration of the fraud. In this letter Mr. Hutton informed the Imperial people that the stock of wallpaper and paints would be purchased by the new company from W. J. Downey "at inventory"; that none of the stock in trade came from the Standard and that it had no interest therein, and that the sale was to be made by Downey to the new company on six months' credit terms. His letter concluded with several significant statements, among them a statement to the effect that if Downey could not make a satisfactory settlement with the Standard within a year he would be compelled to "resort to some honorable means to rid himself of the unendurable load he is now carrying"; "that it would probably pay Mr. Downey to give the Standard Company an ultimatum of either reaching an agreement with him or of his surrendering his agency", and lastly, that "the only entity that could possibly take exception to this new transaction is Standard Company, but if any exception is taken to it, it simply means that they will be biting off their nose to spite their face, and the psychology is all in favor of a successful conclusion." [Tr. p. 54.]

After this letter had been written, Downey recorded a notice of sale of personal property under the Bulk Sales Act of California (Civil Code of California §3440) announcing his intention to transfer his right, title, and interest in and to the stock in trade of wall paper and paints to the Downey Wallpaper & Paint Co., the transfer to occur July 28, 1936, for a consideration of $7500.00 represented by a promissory note executed by the Downey Wallpaper & Paint Co., payable six months from date. [See Petitioner's Exhibit No. 1, Tr. p. 56.] The trans-

fer took place on July 28, 1936, but instead of the transaction involving only $7500.00 worth of his stock in trade, as was set out in the notice of sale of personal property, Downey actually transferred to his new corporation a stock of wallpaper and paints, and other merchandise, inventoried at the sum of $14,194.72 and took a promissory note for that amount instead of $7500.00. [See Findings of Fact, Conclusions of Law and Order Quieting Title to Assets dated April 7, 1939, Finding VI, Tr. p. 106.]

The purchase price actually agreed upon between the parties is demonstrated by Mr. Hutton's letter [Trustee's Exhibit No. 2, Tr. pp. 52, 53], in which Mr. Hutton stated to the Imperial people that the stock of wallpaper and paints was to be purchased "at inventory".

Payment of the $14,194.72 promissory note was repeatedly extended to his family corporation voluntarily by Downey. [See Referee's Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Finding XII, Tr. p. 102], the last extension accorded by him deferring payment of the obligation to June 2, 1939, which was beyond the date of bankruptcy by over six months. [Finding XII, *supra.*]

On or about June 15, 1938, the Standard Coated Products Corporation began pressing its $108,000 claim against the bankrupt Downey. Two-thirds of the $14,194.72 promissory note given by his corporation to himself remained unpaid and constituted the major remaining

portion of his assets. [See Finding XIII, Tr. pp. 111, 112.]

For the purpose of further hindering, delaying, or defrauding his creditors, and particularly the Standard people, and while hoplessly insolvent, Downey then proceeded to satisfy the balance of in excess of $9,000 due on said promissory note, by causing the corporation to issue to him personally 99 shares of its capital stock in satisfaction of the balance due on said promissory note.

The Permit issued by the Corporation Commissioner of the State of California for the sale of stock in Downey's family corporation expressly provided that the stock was to be issued *only for cash.* (Italics ours.) Not having the cash to pay for 99 shares of stock, and in violation of the terms of the Permit, Downey and the corporation exchanged checks between them, without the funds to cover them, for the purpose of manufacturing a fictitious cash consideration for the stock. [See Referee's Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Finding XIII, XIV and XV, Tr. pp. 111, 112, 113.] The day after these 99 shares of stock were issued to Downey, he then took a third step to place the ultimate beneficial interest in his stock in trade further beyond the reach of the Standard Coated Products Corporation. On July 1, 1938 he transferred 49 shares of the additional 99 which had been issued to him, to his wife, Mildred Downey, and 25 shares more to his son, David Downey, both of said transfers being entirely without consideration. [See Referee's Finding XIII, Tr. p. 112.]

By means of the foregoing steps he had effectively completed a fraudulent conveyance of the most lucrative part of his business, to a corporation entirely owned by himself, his wife and his son, and which was dominated and controlled entirely by the bankrupt himself. [See Findings of Fact, etc., Findings XVI and XVII, Tr. pp. 113, 114.]

Thereafter the Standard Coated Products Corporation instituted an action in the Superior Court of the County of Los Angeles for the purpose of having Downey's family corporation, Downey Wallpaper & Paint Co., decreed to be his *alter ego*. [See Findings of Fact, etc., Finding V, Tr. pp. 105, 106.] This resulted in the bankrupt filing a voluntary petition in bankruptcy on November 18, 1938, in the United States District Court for the Southern District of California. Paul W. Sampsell was appointed Receiver in Bankruptcy and took possession of the bankrupt's remaining assets as Receiver. At the time of the Receiver's qualification he found that the Downey Wallpaper & Paint Co. was conducting its business in the same storeroom, in the same building as the bankrupt Downey. The Downey Wallpaper & Paint Co., by consent, turned over all its stock in trade, fixtures and other assets to the Receiver and permitted him to operate the business being conducted in its name, pending further determination of any right, title and interest therein which might be claimed by the bankrupt or his trustee in bankruptcy to be thereafter elected.

Possession of the assets in question passed from the Receiver to the Trustee in Bankruptcy, thus conferring summary jurisdiction over it on the Referee. [See Finding IV, Tr. p. 104.]

The Proceedings to Avoid the Fraudulent Transfer.

Paul W. Sampsell was elected Trustee in Bankruptcy succeeding himself as Receiver. After his qualification as trustee he instituted a summary proceeding before the Referee, against the Downey Wallpaper & Paint Co., a corporation, Wilbur J. Downey, the bankrupt, Mildred Downey his wife, and David Downey his son, the sole and only stockholders, officers and directors of said corporation, seeking to have the transfer of Downey's stock in trade which had been made on July 28, 1936, avoided as fraudulent, and to have the bankrupt's family corporation, Downey Wallpaper & Paint Co., decreed to be his *alter ego,* and to quiet title to the stock in trade and fixtures which had been turned over to him pending hearing, by the respondent, Downey Wallpaper & Paint Co. [Tr. p. 77, *et seq.*]

An order to show cause was issued under date of December 30, 1938, and the issues were tried before Referee Hugh Dickson, commencing January 12, 1939, the trial being concluded, after various adjournments, on April 7, 1939. [Tr. pp. 102, 103.]

After a hearing, in which all the respondents claiming title to the property had appeared and were represented by counsel, the Referee made Findings of Fact, Conclusions of Law and an Order under date of April 7, 1939, in which he decreed that the transfer of the $14,194.72 worth of the bankrupt's stock to his family corporation, the Downey Wallpaper & Paint Co., had been effected, with the actual intent on the bankrupt's part to hinder, delay, or defraud his creditors. [Findings of Fact, etc., Findings VIII, XIII and XVIII, Tr. pp. 108, 111, 114.]

The Referee also found that the respondent corporation, Downey Wallpaper & Paint Co., was at all times during its existence nothing but a sham and a cloak, devised by Downey and the members of his family, for the purpose of preserving his assets for themselves and of hindering, delaying, or defrauding his creditors. [See Finding VIII, Tr. p. 114.] In this Finding the Referee particularly singled out the Standard Coated Products Corporation as the creditor intended to be defrauded.

Based on those Findings and his Conclusions of Law, the Referee entered an order under date of April 7, 1939, decreeing the trustee to be the owner of the assets in question, quieting title thereto against Downey, his wife, his son, and the Downey Wallpaper & Paint Co., decreeing the transfer to have been fraudulent, and the property in the possession of the Downey Wallpaper & Paint Co., to be a part of the assets of the bankrupt estate, which had been secreted and concealed in its name as a fraudulent transferee, and directing that the stock in trade, furniture, fixtures and equipment, and all other assets be marshaled in the estate of the bankrupt Downey and administered for the benefit of his creditors. [See Order Quieting Title, etc., Tr. p. 116, *et seq.*]

This order was never appealed from and became final. In conformity therewith, the trustee sold the assets recovered from the Downey Wallpaper & Paint Co., and collected the purchase price thereof and proceeded with the administration of the estate.

Imperial Paper and Color Corporation's Subsequent Connection With the Case.

During the period between the organization of Downey's family corporation, in July of 1936, and the adjudication of Downey as a bankrupt, the Imperial Paper and Color Corporation had been selling the Downey Wallpaper & Paint Co., its merchandise on credit. At the date of Downey's bankruptcy and when the assets of the family corporation were turned over to the Receiver, the Downey Wallpaper & Paint Co., was indebted to the Imperial Paper and Color Corporation in the sum total of $5,415.95, represented by four promissory notes bearing date of September 26, 1938. [See Exhibit attached to Claim of Imperial Paper and Color Corporation, Tr. p. 10, *et seq.*]

After the trustee obtained his order of April 7, 1939 decreeing the transfer of Downey's assets to his family corporation to have been fraudulent and marshaling its assets into the bankrupt estate, the Imperial Paper and Color Corporation filed its proof of debt in the bankruptcy matter of Downey, in the sum of $5,415.95. However, instead of filing an ordinary general claim against the estate of Downey, the Imperial Paper and Color Corporation asserted priority over other creditors with regard to its claim. [Tr. p. 70, *et seq.*] The trustee filed objections to the allowance of the claim as prior, under date of June 5, 1939. [Tr. p. 18, *et seq.*]

Thereafter, under date of July 14, 1939, the Imperial Paper and Color Corporation petitioned for an order to

show cause against the trustee, praying for an order decreeing its claim to be prior and for the first time asserting an *equitable lien* on the former assets of the Downey Wallpaper & Paint Co. [Tr. p. 14, *et seq.*] The assertion of a equitable lien at that time is absolutely contrary to the statement in the original proof of debt filed by the Imperial, "that said claimant has not had or received any manner of security for the said debt whatever." [Tr. p. 8.]

The objections of the trustee to the prior claim and the petition of the Imperial Paper and Color Corporation for priority and for the recognition of an equitable lien in its favor were consolidated for trial before the Referee and were heard on August 29, 1939. The Referee entered an order allowing the claim of Imperial Paper and Color Corporation as a general unsecured claim. He denied it any status of priority and refused to recognize any equitable lien on the funds derived from the sale of the fraudulent transferee's assets. [Tr. pp. 31 to 35.]

A petition for review filed by the Imperial Paper and Color Corporation was denied by United States District Judge George Cosgrave on November 17, 1939, after hearing and argument. [Tr. p. 36.]

An appeal was thereupon taken by the Imperial to the United States Circuit Court of Appeals for the Ninth Circuit and the orders of Judge Cosgrave and Referee Dickson were reversed, with directions to enter an order allowing the claim of Imperial Paper and Color Corporation as a prior claim. [See Opinion of United States Circuit Court of Appeals for the Ninth Circuit, filed August 30, 1940, Tr. p. 200, *et seq.*]

Petition of the trustee for rehearing was denied by the Circuit Court of Appeals on September 7, 1940.

The Questions Involved Here.

1. May a creditor of a fraudulent transferee of a bankrupt, who participated in the bankrupt's fraud, and who extended credit thereafter to the bankrupt's fraudulent transferee, be permitted, after the fraudulent transfer has been avoided by the trustee by final decree, and the fraudulent transferee decreed to be nothing but the *alter ego* of the bankrupt, have its claim proved and allowed in full against the bankrupt estate as a claim entitled to priority, in the absence of any lien, equitable or otherwise, on the property recovered by the trustee?

2. Is there anything in Section 64 of the Bankruptcy Act of the United States, either of 1898 or 1938, which permits such priority classification, as to assets which have become a part of the bankrupt estate?

3. Is a trustee in bankruptcy, in proceeding to avoid transfers made by the bankrupt in actual fraud of his creditors, under the provisions of Section 70-e of the Bankruptcy Act of the United States, together with the Fraudulent Conveyance Act of the State in which the fraudulent transfer occurred, required, before availing himself of the fruits of his recovery, to pay off all the unsecured creditors of the fraudulent transferee, in full, particularly where such creditor or creditors instigated the incorporation of the fraudulent transferee and extended credit to it with full knowledge of the transfer and with notice that existing creditors of the fraudulent transferor might object thereto?

ARGUMENT, POINTS AND AUTHORITIES.

The policy of distribution to creditors under the Bankruptcy Act is equality of distribution of the net assets in the hands of the trustee.

Section 65-a of the Bankruptcy Act (11 U. S. C. A., §105-a) reads:

> "Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured."

Claimants holding liens on the bankrupt's property are protected in so far as valid liens are concerned, under the provisions of §67-b of the Bankruptcy Act, which, in so far as material here, reads as follows:

> "The provisions of §60 of this Act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or any State or subdivision thereof, created or recognized by the laws of the United States or of any State may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition in bankruptcy. * * *"

The only other exception to the provisions contained in §65-e requiring dividends of an equal per centum to be paid on all allowed claims are the statutory priorities set forth in §64-b of the Bankruptcy Act (11 U. S. C. A. §104-b), which create priority in favor of the following classes of claims:

1. The actual and necessary costs and expenses of preserving the estate subsequent to the filing of the

petition, the filing fees paid by creditors in involuntary proceedings, reimbursement of creditors' expense involved in recovering fraudulently transferred property, costs and expenses of administration, including opposition to bankrupt's discharge, witness fees and attorneys' fees.

2. Claims of workmen, servants and clerks for wages earned, in a sum not to exceed $600.00, if earned within three months before the date of the filing of the petition.

3. Reimbursement to creditors for successful resistance to confirmation of a composition, or a revocation thereof.

4. Taxes due and owing to various political bodies.

5. Debts owing to any person who by the laws of the United States is entitled to priority, and landlords prior rent, within certain restrictions allowed by law.

Section 65-a providing for "dividends of an equal per centum" is further strengthened by the reiteration of the principle contained therein, in different language. In Section 65-e of the Bankruptcy Act (11 U. S. C. A. §105-e) it is provided:

"A claimant shall not be entitled to collect from a bankrupt estate any greater amount than shall accrue *pursuant to the provisions of this Act.*" (Italics ours.)

Upon the filing of the petition in bankruptcy by Wilbur J. Downey the trustee was vested by operation of law with title of the bankrupt to,

> "(4) All * * * property transferred by him in fraud of his creditors, and
>
> "(5) All * * * property, including rights of action which, prior to the filing of the petition, he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered."

See:

Bankruptcy Act §70-a (11 U. S. C. A. §110-a).

The fraudulent transfer of Downey's stock in trade was avoided by the trustee in the proceedings against the Downey Wallpaper & Paint Co., its officers, directors, and stockholders, under the provisions of §70-e of the Bankruptcy Act (11 U. S. C. A. §110-e) which reads as follows:

> "All property of the debtor affected by any such (fraudulent) transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such tranfer or obligation shall be avoided by the trustee for the benefit of the estate. The trustee shall reclaim and recover such property or *collect its value* from and avoid such transfer or obligation against whomever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision (e) is valid under applicable Federal or State laws." (Parenthetical matter ours.)

Bouvier defines "value" as:

> "The utility of an object. The worth of an object in purchasing other goods. The first may be called value in use. The latter value in exchange."
>
> Baldwin's Century Edition of Bouvier's Law Dictionary, 1926, at page 1209.

The value of the property fraudulently transferred was recovered by the trustee, so far as possible, in the form of other similar merchandise which was in the place of business of the fraudulent transferee Downey Wallpaper & Paint Co., in replacement of the merchandise which it had fraudulently received from Downey and sold in the course of its business.

The Rights of the Imperial Paper and Color Corporation Against the Proceeds of the Sale of the Fraudulently Transferred Property Recovered by the Trustee.

In the proceeding to avoid the fraudulent transfer, the trustee proceeded against the only proper parties, the fraudulent transferee, Downey Wallpaper & Paint Co., its stockholders, officers and directors. We do not believe the stockholders, officers and directors, as such, were necessary parties to the proceeding, but in an excess of caution we joined them as parties defendant.

The *creditors* of the Downey Wallpaper & Paint Co. were in nowise proper parties to the action, particularly in view of the fact that none of them had a lien on the property sought to be recovered by the trustee.

Upon recovery of the stock in trade in possession of the fraudulent transferee and the conversion of the same into cash, as constituting the value of the property

fraudulently transferred, the fund in the hands of the trustee then became available for dividends of an equal per centum to be paid to all creditors of the bankrupt who had proved their claims.

Bankruptcy Act, §65-a;

Moore v. Bay, 284 U. S. 4, and cases there cited;

Buffum v. Barceloux Co., 289 U. S. 227.

In view of the holding of the referee in the fraudulent conveyance proceeding that the Downey Wallpaper & Paint Co., was nothing more nor less than the alter ego of Wilbur J. Downey, equity would require that its creditors be treated on the same basis as Downey's creditors in the event of the liquidation of its assets. In other words, the creditors of Downey's alter ego corporation should be regarded as creditors of Downey and permitted to share with the individual creditors of Downey on an equal basis in the distribution of the assets of Downey's bankrupt estate, even though they, or some of them, might have participated in Downey's fraud.

We have examined a number of cases in various jurisdictions, holding that a fraudulent transferee or a person participating in the perpetration of a fraudulent transfer, if a creditor, is to be permitted, after the transfer has been avoided by the trustee, to share on an equal basis with other creditors in the distribution of dividends, but always on *an equal basis.*

Buffum v. Barceloux Co., 289 U. S. 227;

Barks v. Kleyne, 15 Fed. (2d) 153 8 Am. B. R. (N. S.) 659;

Keppel v. Tiffin Savings Bank, 197 U. S. 356, 13 Am. B. R. 552 (involving a fraudulent preference).

But nowhere in our research have we found an authority which rewards a party instigating or participating in a fraudulent transfer by advancing his claim against the bankrupt to the classification of a priority creditor who must be *paid in full* before the general creditors may share in the fruits of the trustee's recovery, as in the case here. (Italics ours.)

It is undisputed that the Downey Wallpaper & Paint Co., was organized by Downey, originally, at the instigation of the Imperial Paper and Color Corporation, through its president, in a conference with Downey at Glenns Falls, New York in April, 1936. [Tr. p. 41.]

It is undisputed that the Imperial people knew that this corporation was being organized as early as June 17, 1936, and that Downey's stock in trade was to be "sold" to it on six months credit and that the object of this transaction was to *protect this new corporation from being involved with the financial status existing between Downey and the Standard Textile Company;* (italics ours) namely, a colossal indebtedness of $108,000 owing by Downey to the Standard.

There is no question but that the Imperial people knew that Downey's proposed plan of reorganization had been rejected by the Standard Textile Company and that Downey intended, by the time Attorney Hutton's letter was received by the Imperial, to be going ahead "functioning full blast as the Downey Wallpaper & Paint Co." [See Letter of Frank S. Hutton dated June 17, 1936, Trustee's Exhibit No. 1, Tr. pp. 50, 51.]

There is no dispute that the Imperial people were again warned a week later that the Standard Textile might seriously object to the transaction, but, as Attorney Hutton

put it in his letter, if this large creditor saw fit to object to Downey's arrangement, it would simply be "biting off its nose to spite its face," and the Imperial was jubilantly informed by Attorney Hutton that "the psychology is all in favor of a successful conclusion."

[See Letter of Attorney Frank S. Hutton dated June 24, 1936, Trustee's Exhibit No. 2, Tr. pp. 52 and 54.]

Thus, not in good faith, but with full knowledge of the consummation of the fraud which it had inspired in the mind of Downey, the respondent here sold merchandise to Downey's dummy corporation on open account, later merged into a promissory note, and at the date of bankruptcy, we submit, had no lien whatsoever on any part of this family corporation's stock in trade, or other assets. Nevertheless, the Circuit Court of Appeals for the Ninth Circuit has recognized and sought to impress an equitable lien in favor of the Imperial Paper and Color Corporation upon the assets of Downey's fraudulent transferee, notwithstanding the fact that such a lien on personal property in California is absolutely impossible.

This will be discussed more in detail later.

There were only two theories on which the Imperial people could possibly be entitled to have their obligation paid on a more favorable basis than other creditors of Downey; namely, by bringing it within the express provisions of §64-a of the Bankruptcy Act, or by successfully asserting and maintaining a lien on the assets recovered by the trustee and sold in the proceeding brought against the Downey Wallpaper & Paint Co.

We have heretofore set out the classes of creditors who are entitled to priority under §64-a.

An examination of the authorities indicates that it has been the policy of the courts to consistently construe §64-a strictly and not to in any way extend its provisions beyond the clear language of the section.

Remington on Bankruptcy, §2857.70 succinctly sums up this policy in the following language:

> "Equitable Priorities, So-called. — Attempts are sometimes made by resourceful creditors to obtain priority on 'general equitable principles.' But priorities in bankruptcy are purely statutory and 'state law' means a legislative enactment. It follows that though there may be an 'equitable lien,' there can be no equitable priority, unless recognized by the Bankruptcy Act itself, as in new Section 77." (11 U. S. C. A. §205.)

In the *Matter of Newmark Shoe Stores, Inc.*, 3 Fed. Supp. 293, the court, in ruling that a deposit made with a bankrupt corporation by certain store managers, could not be refunded on equitable principles, and after having quoted §64-b of the Bankruptcy Act, as it then read, said:

> "The apparent hardship of the ruling herein announced is regrettable, but courts may not, without warrant, extend the clearly defined limitations of the Bankruptcy Act and create preferred creditors, in derogation of the rights of general creditors."

In *Southern Bell Telephone & Telegraph Co. v. Caldwell*, 67 Fed. (2d) 802, 24 Am. B. R. (N. S.) 1, the Circuit Court of Appeals for the Eighth Circuit, in a case where a telephone company had rendered public utility services to a bankrupt telephone company, under the requirements of public policy, in which the contention was

made that, in a mortgage foreclosure suit against a public utility in the Federal Courts, the equity court would have required payment in full of its claim out of the insolvent company's assets, by reason of the claimant's public service character, and where the referee had overruled the contention and was sustained by the District Court, said:

> "In this case it is plain that the Southern Bell Company had no 'lien' upon any specific property of the bankrupt, nor upon the bankrupt's general estate, resulting from any express or implied provision of the contract under which the services were rendered. No statute of a state or the United States accorded such a lien or priority, and there is no power vested in the Bankruptcy Court to order preferential payments because 'of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence.' Section 64-b of the Bankruptcy Act, also Section 104-b, Title 11, U. S. C. A. §107-b, Title 11, U. S. C. A.
>
> "It is conceded that there is no decision in bankruptcy affording any support to the appellant's claim of priority. The equity foreclosure cases like Miltenberger v. Logansport C. & S. W. R. Co., 106 U. S. 286; Kneeland v. American Loan & Trust Co., 136 U. S. 89; Southern Ry. Co. v. Carnegie Steel Co., 176 U. S. 257; Gregg v. Metropolitan Trust Co., 197 U. S. 183, or the Admiralty case, New York Dock Co. v. The Poznan, 274 U. S. 117; Chicago & Alton R. Co. v. U. S. & Mexican Trust Co., 225 Fed. 940, are without application, and we have no occasion to review them.
>
> "Affirmed."

The Eighth Circuit Court of Appeals in *United States Fidelity and Guaranty Co. v. Sweeney,* 80 Fed. (2d) 235, 29 Am. B. R. (N. S.) 705, said:

> "The government must look to the Bankruptcy Act (§104, Title 11, U. S. C. A.) and not to §191, Title 31, U. S. C. A. Guarantee Title & Trust Co. v. Title Guaranty & S. Co. 224 U. S. 152, 27 Am. B. R. 873. Taxes due the government are, of course, entitled to priority of payment in the administration of the estate of a bankrupt, but the priority which the Bankruptcy Act creates is in the assets of the bankrupt's estate, and it does not give priority over valid liens. Richmond v. Bird, 249 U. S. 174; City of Tampa v. Commercial Building Co., 54 Fed. (2d) 1057, 19 Am. B. R. (N. S.) 199. The statute provides that certain claims shall have priority in advance of payment of dividends to creditors. Manifestly, 'dividends,' as used in this statute, refer to partial payment to general creditors. Richmond v. Bird, *supra.*"

A similar strict construction was followed by the Circuit Court of Appeals for the Ninth Circuit in *Federal Housing Administrator v. Moore,* 90 Fed. (2d) 92, 34 Am. B. R. (N. S.) 187, in which case the Federal Housing Administrator, acting for and on behalf of the United States, sought priority under the provisions of §64-b of the Bankruptcy Act, on the theory that the Federal Housing Administrator was an agency of the United States Government and was entitled to priority. In overruling his contention the Ninth Circuit Court of Appeals said:

> "This contention cannot prevail. *Appellant is not the United States.* The United States is not a party to this proceeding. The bankrupt was never indebted to the United States. Its indebtedness was to the

bank. The United States has no claim against the bankrupt estate, and has asserted none. If the United States had any such claim, it could, and undoubtedly would, assert it in its own name. There is no reason why, in a bankruptcy court or elsewhere, the United States should call itself 'Federal Housing Administrator.'"

The strict construction placed on §64-b of the Bankruptcy Act by the Ninth Circuit was followed by the United States Circuit Court of Appeals for the Third Circuit in the *Matter of Hansen Bakeries, Inc.*, 103 Fed. (2d) 664, 40 Am. B. R. (N. S.) 71, in which the foregoing language in the Ninth Circuit case was quoted with approval. Thereafter the case of *United States v. Edward H. Marxen* came before the Circuit Court of Appeals for the Ninth Circuit on a claim held by the Federal Housing Administrator, proved in the bankruptcy proceeding of the Monterey Brewing Co., in the name of the United States of America. The appeal from the order of the referee and the District Court denying priority apparently came before the Ninth Circuit Court of Appeals with a different personnel of judges sitting than had decided the case of *Federal Housing Administrator v. Moore*, and we assume they were not in full accord with the three judges who had decided that case. The question was therefore certified to this court in *United States v. Marxen*, 307 U. S. 200, 39 Am. B. R. (N. S.) 494, in which case this court upheld the strict construction of §64-b and denied priority to the Federal Housing Administrator under the provisions of §64 of the Bankruptcy Act.

In *Davis v. Pringle*, 268 U. S. 315, 5 Am. B. R. (N. S.) 969, a case where the United States Railroad Administration sought priority on claims for freight charges

arising during federal control of the railroads by the United States in 1918. Mr. Justice Holmes, after an extended discussion of the provisions of §64 of the Bankruptcy Act, said:

> "We attach little value to this logical concatenation as against the direct effect of §64, taken according to the normal uses of speech. It is incredible that after the conspicuous mention of the United States in the first place at the beginning of the section and the grant of a limited priority, Congress should have intended to smuggle in a general preference by muffled words at the end. * * * We are confirmed in our opinion by the fact that in earlier bankruptcy acts a priority was given to the United States in express terms, and that, for instance, in the Act of March 2, 1867, (Chap. 176, §28, 14 Stat. 517, 530), 'fifth,' persons entitled to priority by the laws of the United States are mentioned when the United States could not have been meant, having been fully secured by the same section, 'second.' If it be legitimate to look at them (Schall v. Camors, 251 U. S. 239, 250) the bills that were before Congress when the present law was passed contained the clause relied upon, but showed by their context that they could not refer to the United States. There was a change of purpose from that of the earlier acts. (Guarantee Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152, 158, 27 Am. B. R. 873.) Public opinion as to the peculiar rights and preferences due to the sovereign has changed. We agree with the view of this point taken by the Chief Justice and Justices Van Devanter and Clarke in United States Shipping Board Emergency Fleet Corporation v. Wood, 258 U. S. 549, at a time when it was not necessary for the majority to speak upon it. *The priority claimed by the United States is not given to it by the law.*" (Italics ours.)

In *State of Missouri v. Ross*, 299 U. S. 72, 32 Am. B. R. (N. S.) 167, in discussing the provisions of §64-a and §64-b of the Bankruptcy Act, this court said:

> First: "By this enumeration it is clear that Congress intended to establish seven distinct classes of indebtedness and establish their priority in respect of one another in the order set forth. * * * If it had been intended to establish priorities as among the governmental units named, in the order in which they appear in the sixth paragraph, the very structure of §64-b plainly suggests that each would have appeared under a separate numeral instead of all being grouped under a single numeral. * * *
>
> Moreover, Congress in the face of these (previously cited) decisions has permitted the clause as it now appears in paragraph (b) (6) to stand for many years without change in its phraseology, although amending that portion of the Bankruptcy Act in other particulars. This is persuasive evidence of the adoption by that body of the judicial construction. United States v. Ryan, 284 U. S. 167, at Page 175; Sessions v. Romadka, 145 U. S. 29.
>
> Second: The State urges that the question is controlled by paragraph (b) (7) which gives priority in the seventh degree to 'debts owing to any person who by the laws of the States, * * * is entitled to priority.'
>
> Section 3152, Rev. Stat. Missouri, 1929. (Mo. St. Ann. §3152, p. 4969) provides that in cases of insolvency, debts due the State shall be first satisfied, and that this priority shall extend to cases in which an act of bankruptcy is committed. The contention is that unpaid taxes constitute debts, and therefore fall within the seventh paragraph. But this conclusion must be rejected, for conceding that taxes are debts,

they are carved out of the general provisions of paragraph (b) (7) and put in a special class under paragraph (b) (6), and thus falling within the rule that special provisions prevail over general ones which, in the absence of special provisions, would control. Townsend v. Little, 109 U. S. 504; McKee v. United States, 164 U. S. 287; Kepner v. United States, 195 U. S. 100; In re Rouse, Hazard & Co., 91 Fed. 96, 1 Am B. R. 234; In re Slomka, 122 Fed. 630, 631, 9 Am. B. R. 635."

In *Moore v. Bay,* 284 U. S. 4, 18 Am. B. R. (N. S.) 675, this Court said:

"The Circuit Court of Appeals affirmed an order of the District Judge giving the mortgage priority over the last creditors. Whether the Court was right *must be decided by the Bankruptcy Act* since it is superior to all state laws upon the subject. Globe Bank & Trust Co. v. Martin, 236 U. S. 288. * * *" (Italics ours.)

"The rights of the trustee by subrogation are to be enforced for the benefit of the estate. The Circuit Courts of Appeal seem generally to agree, as the language of the Bankruptcy Act appears to us to imply very plainly that what thus is recovered for the benefit of the estate is to be distributed in 'dividends of an equal per centum on all allowed claims, except such as have priority or are secured.' Bankruptcy Act, §65, U. S. C. Title 11, §105] In re Kohler (C. C. A. 5th Cir.), 159 Fed. 871; Mullen v. Warner, 11 Fed. (2d) 62, 7 Am. B. R. (N. S.) 93, (C. C. A. 4th Cir.); Campbell v. Dalbey, 23 Fed. (2d) 229, 11 Am. B. R. (N. S.) 336, (C. C. A. 5th Cir.); Cohen v. Schultz, 43 Fed. (2d) 340, 16 Am. B. R. (N. S.) 563, (C. C. A. 3rd Cir.); Globe Bank & Trust Co. v. Martin, 236 U. S. 288, 34 Am. B. R. 162."

In *State of Missouri v. Earhart,* 111 Fed. (2d) 992, 42 Am. B. R. (N. S.) 634, the Circuit Court of Appeals for the Eighth Circuit said:

> "Appellants also claim a special priority over other claimants, on the ground of the sovereignty of the State. Priorities are to be determined only by federal law and according to the controlling statutes, New Jersey v. Anderson, 203 U. S. 483, 17 Am. B. R. 63; Davis v. Pringle, 268 U. S. 315, 5 Am. B. R. (N. S.) 969; Missouri v. Ross, 299 U. S. 72, 32 Am. B. R. (N. S.) 167. The statute grants to the state no priorities on the ground of its sovereignty."

In the *Matter of Kohler,* 159 Fed. 871, the Circuit Court of Appeals for the Sixth Circuit said:

> "One object of the bankruptcy law is to prevent preferences and secure equality. The letter of the law from which we have quoted provides for an equal distribution."

See also in the *Matter of Conklin,* 110 Fed. (2d) 78, 42 Am. B. R. (N. S.) 142 (C. C. A. 2d Cir.).

We believe the foregoing sufficiently disposes of any question of a foundation for the allowance of this claim as prior under the provisions of §64 of the Bankruptcy Act.

We shall now proceed to a discussion of the question as to whether or not the claim should be accorded priority on the theory that the claimant had an equitable lien on all of the assets of the fraudulent transferee, Downey Wallpaper & Paint Co., regardless of whether those assets had been purchased from the claimant, Imperial Paper and Color Corporation, or from other manufacturers and wholesalers, and regardless of whether or not the assets had been paid for or had been purchased on credit, with the purchase price remaining unpaid.

Imperial Paper and Color Corporation Did Not Have an Equitable Lien on the Property of the Downey Wallpaper & Paint Co., for the Reason That There Can Be No Such Thing as an Equitable Lien on Personal Property in California.

From the earliest days of California Jurisprudence there has been in existence in that State a policy absolutely hostile to secret liens. In order for a creditor to obtain and retain a lien on personal property one of two steps must be taken. The person seeking the lien must either have a chattel mortgage executed, acknowledged, and recorded in like manner as grants of real property (Civil Code of California, §2957), or the personal property sought to be impressed with a lien must be immediately delivered to the lienholder by the lienor, and actual and continued change of possession of the personal property must be retained by the holder of the lien during the life of the lien (Civil Code of California, §3440). Otherwise, the lien is absolutely void as against those who are the creditors of the lienor while he remains in possession, the successors in interest of such creditors and against any person on whom his estate devolves in trust for the benefit of others than himself. The only exceptions to this rigid rule with regard to liens on personal property are, choses in action, ships or cargoes at sea, or in a foreign port, and personal property deposited in a warehouse against which warehouse receipts may be issued under the Warehouse Receipts Act. We have, however, no such situation here.

It is not contended that the property on which the Imperial Paper and Color Corporation now claims an equitable lien, or any part of it, was in the Imperial's possession at any time after it had been sold to the Downey Wallpaper & Paint Co., neither is it contended

that title to any portion of these assets had been retained or sought to be retained by the Imperial. Its contention simply boils itself down to this:

> "We sold merchandise worth in excess of $5400.00, on open account, to the Downey Wallpaper & Paint Co. It has not paid us for that merchandise, and we are entitled to an equitable lien superior to the rights of the trustee of Wilbur J. Downey, who has seized this merchandise and the other assets of the Downey Wallpaper & Paint Co., as representing the value of property fraudulently transferred to it by the bankrupt Downey."

It cannot be disputed that the trustee of Wilbur J. Downey was a creditor of the Downey Wallpaper & Paint Co., from the very moment of the filing of the petition in bankruptcy. It cannot be disputed that the Downey Wallpaper & Paint Co. made itself liable to the Standard Coated Products Corporation from the moment that it accepted a fraudulent transfer of $14,000 worth of Downey's stock in trade back in 1936, with full knowledge of Downey's fraudulent intent. From the moment that Downey transferred this merchandise to his family corporation it was liable to the creditor defrauded by the transaction, for the full value of the merchandise, and the trustee as a successor in interest of that creditor, was vested with the creditor's rights. (Bankruptcy Act, Secs. 70a and 70e.)

At the time of the transfer in 1936 Section 3439 of the Civil Code of California read as follows:

> "Every transfer of property or charge thereon made, every obligation incurred, and every judicial proceeding taken, with intent to delay or defraud any creditor or other person of his demands, is void

against all creditors of the debtor, and their successors in interest, and against any person upon whom the estate of the debtor devolves in trust for the benefit of others than the debtor."

At the time of said transfer in 1936, the Bankruptcy Act of 1898 as it then read, provided as follows in §70-e of said Act (11 U. S. C. A. §110-e):

> "The trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided, and may recover the property so transferred, *or its value* from the person to whom it was transferred, unless he was a *bona fide* holder for value prior to the date of the adjudication. * * *" (Italics ours.)

The present Bankruptcy Act as amended in 1938, provides in the same section:

> "The trustee shall reclaim and recover such property or *collect its value* from and avoid such transfer or obligation against whomever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision (e) is valid under applicable Federal or State laws."
>
> (Section 70-e, 11 U. S. C. A. §110-e.)

Under the provisions of §3439 of the Civil Code of California, as construed by the Supreme Court, the trustee or defrauded creditors have a right to recover the value of the fraudulently transferred property from the fraudulent transferee if the property has been disposed of by him and is not available.

In the early case of *Swinford v. Rogers,* 23 Cal. 234, the Supreme Court said:

> "The appellants also contend that the Court erred in rendering a personal money judgment against the fraudulent vendees, Smith & Rogers, and that the allegations of the complaint are not sufficient to sustain such a judgment. As a general rule a Court of Equity declares the fraudulent conveyance void, and directs that the property be sold for the satisfaction of the creditors' debt; but where a fraudulent vendee sells the property, or converts the same to his own use, that kind of relief is rendered impracticable, and he is clearly liable to account for the value thereof, and pay the same to the creditors of the vendor. Ludlow v. Kidd, 4 Ham. 244; Sparrow v. Chester, 19 Me. 79; Jones v. Henry, 3 Littell, 428."

See also:

Buffum v. Barceloux, 289 U, S. 227.

In *Cooper v. Nolan,* 138 Cal. 248, the Supreme Court of California, in modifying a decree providing for the imprisonment of a fraudulent transferee until he should have paid a money judgment in the sum of $4,933.25, collected out of fraudulently transferred property, received by him, approved the judgment for the value, in this terse language:

> "The decree to that extent is justified by the nature of the action. If the defendant should fail to comply with the order of the court to turn over to the assignee in insolvency what he received from the debtor, W. S. Nolan, or the proceeds thereof now in his hands, the court might then take steps to enforce a compliance with its decree; but in such case the de-

fendant should first be cited to show cause why he does not comply with the order of the court, and be given an opportunity to be heard."

The Court merely relieved the defendant in that case from summary imprisonment under the money judgment rendered.

We cite these cases in view of the attitude taken by the Circuit Court of Appeals, that the property seized by the trustee under the Order of April 7th and sold, was not the identical merchandise which Downey fraudulently transferred to the Downey Wallpaper & Paint Co.

The Circuit Court of Appeals says:

"Appellee never got possession of that stock or any part of it. The referee's order dealt, not with that stock, but with other property of the corporation —property which appellee took possession of and sold—and with the proceeds thereof in appellee's hands. That property was not purchased from the bankrupt. The bankrupt never owned it, never had possession of it, never sold it or attempted to sell it. Therefore, the fact, if it be a fact, that the sale on July 28, 1936, of the bankrupt's then existing stock of wallpaper and paint was made with intent to delay or defraud the bankrupt's creditors is, for present purposes, immaterial."

Therefore, from the very date of the transfer down to the date of the order of the referee of April 7, 1939, either the Standard Coated Products Corporation or the trustee in bankruptcy was a creditor of the Downey Wallpaper & Paint Co., and no secret lien could prevail against such creditor's rights in California.

That the declared policy of the State of California has been consistently hostile to secret liens was recognized by the Circuit Court of Appeals for the Ninth Circuit in *Bank of America National Trust and Savings Association v. Sampsell,* 114 Fed. (2d) 211, 44 Am. B. R. (N. S.) 88, in the following language:

> "Giving effect to the rule announced in the decided state cases, it is fairly clear that the proper interpretation of §195 of the Vehicle Code is that a mortgage on motor vehicles which is not promptly recorded is void as to creditors, and as to subsequent purchasers and encumbrancers whose interests arise prior to the date of compliance with the statute. This construction is in harmony with the declared policy of the state, hostile to secret liens. California Civil Code, §3440; Ruggles v. Cannedy, 127 Cal. 290, 53 Pac. 911; Noyes v. Bank of Italy, 206 Cal. 266, 274 Pac. 68; Washington Lumber & Millwork Co. v. McGuire, 213 Cal. 13."

That case dealt with a chattel mortgage in which the recordation was unduly delayed.

This policy of hostility toward secret liens on personal property manifested itself for the first time that we have been able to discover, in the early case of *Chenery v. Palmer,* 6 Cal. 119, in which the Supreme Court annulled a Bill of Sale intended as a mortgage but not accompanied by change of possession, in the following language:

> "If the bill of sale was, by a private understanding between the parties, to operate only as a mortgage, then it was a secret trust to the extent of the surplus over the debt secured, for the benefit of the vendor, and void by the eleventh section of the same

statute. It was placing the property beyond the reach of his creditors, who certainly had the right, except it may be under peculiar circumstances, to avail themselves of the surplus. In what manner this could be done, it is unnecessary here to determine, and may depend upon the circumstances of each case."

On rehearing, the Court said:

"If the relation of the parties had been that of bailor and bailee, or pledgor and pledgee, then there would be no doubt but the plaintiff might assert his claim for these advances thus made upon the property *in his possession.* (Italics ours.) There is no evidence, however, that the original contract was ever abandoned, in fact, it appears from the testimony of Hutchinson that these same advances were contemplated and agreed on at the time of the original sale or mortgage. Under these circumstances the contracts must be regarded as an entirety, and however honest the intentions of the parties, the law from motives of public policy having declared the contract void, all subsequent acts under it must relate to its inception, and are alike tainted with fraud.

We are disposed to regard this case as a hard case, but do not see how the consequences can be avoided, as any other rule would enable a party to cure a fraudulent conveyance by subsequent payments or advancements made in good faith."

The rule was reiterated in *Hackett v. Manlove,* 14 Cal. 85, and again in *Woods v. Bugby,* 29 Cal. 467. In the latter case the Court said (page 475):

"The rule which our statute prescribes admits of no excuse dispensing with an actual and continued

change of possession of the property sold, assigned, or mortgaged, in order to place it beyond the reach of the creditors named therein, and when consulting the decisions of other Courts than our own, it should be remembered that *we have a statute more definite and exacting than those under which the decisions of such other Courts were made.*" (Italics ours.)

In *Ruggles v. Cannedy,* 127 Cal. 290, one of the outstanding landmarks on secret liens in California, the Supreme Court said (page 297):

"Even more untenable does this argument seem when consideration is had for the manifest policy of these laws. The very object of them all, the reason for their being, is to prevent secret liens upon and interests in personal property. Says Chancellor Kent (2 Kent's Commentaries, §523): 'The policy of the law will not permit the owner of personal property to create an interest in another, either by mortgage or absolute sale, and still continue to be the visible owner. The law will not stop to inquire whether there was actual fraud or not, for it is against sound policy to suffer the vendor to remain in possession. * * * It necessarily creates a secret encumbrance as to personal property, when to the world the vendor or mortgagor appears to be the owner, and he gains credit as such, and is enabled to practice deceit upon mankind.' In Palmer v. Howard, 72 Cal. 293, it is said: 'It must be remembered, in general that the policy of the law is against upholding secret liens and charges to the injury of innocent purchasers or encumbrances for value, and, in particular, that mortgages of personal property are permitted only in certain specified cases, and this only upon the observance of certain formalities designed to secure good faith, and to give notice to the world

of the character of the transaction.' This language has very recently been quoted with approval in Stockton Savings Bank v. Purvis, 112 Cal. 230."

In the case of *Ruggles v. Cannedy,* the Supreme Court went so far as to lay down the rule that chattel mortgages, when allowed by law, in California, must be immediately recorded, notwithstanding the fact that the Chattel Mortgage Statute, Civil Code, §2957, does not specify the time in which the chattel mortgage must be recorded.

The Supreme Court held that the policy of the law regarding liens on personal property as expressed by §3440 of the Civil Code required immediate recordation in place of immediate delivery followed by actual and continued change of possession. Said the Court at page 298 of the opinion:

"We conclude upon this question that our law requires immediate recordation in lieu of immediate delivery, and that when such recordation is not effected the mortgage is void as against creditors of the mortgagor. The penalty for a failure to record promptly in the case of a mortgage is identical with the penalty under section 3440 for a failure to deliver promptly in the case of a sale. In either case the failure results in a legal fraud against those whom the statute enumerates and protects. Section 3440 excepts a 'mortgage when allowed by law' from the requirement of immediate delivery, because, and only because, the recordation takes the place of delivery. It certainly cannot be said that it was the design of the legislature to exclude the articles of personal property affected by such mortgages from the operations of the laws forbidding secret liens."

The Supreme Court of California, again in *Noyes v. Bank of Italy*, 206 Cal. 266, took a definite stand against even an improperly recorded lien in annulling a chattel mortgage given by a bankrupt to the Bank of Italy which had actually been filed for record in the Recorder's office, but lacked the formality of an acknowledgment as required by the Civil Code, §2957.

Before bankruptcy ensued the bank took actual, physical possession of the property, assuming to act under the terms of the chattel mortgage. The trustee sued for conversion and recovered judgment against the bank. On appeal, the Supreme Court disposed of the defective lien in this language (page 272):

> "It is further contended by the defendant that the chattel mortgage should have been received in evidence to show the good faith of the mortgagee. Good faith is not an element bearing on its admissibility. The code section makes the mortgage void as to those mentioned regardless of the good or bad faith of the mortgagee."

Certainly if the Supreme Court of California intended to recognize such a device as an equitable lien on personal property, the situation portrayed in *Noyes v. Bank of Italy* was one which would have justified it. There the bank had actually loaned the bankrupt $8705.65, which had been used in processing the canned goods covered by the mortgage. It had taken a chattel mortgage in good faith and had filed it with the Recorder three days after its execution. The only defect in it was the lack of an acknowledgment, in that the Chattel Mortgage Statute of California (Civil Code, §2957) required that it be acknowledged in like manner as a grant of real property, in order to be valid as against the claims of creditors.

Even then, the Bank had taken actual, physical possession of the property a substantial time prior to the filing of the petition in bankruptcy and certainly was in a position to have appealed to the tender conscience of the Chancellor in Equity to recognize an equitable lien on the property, if such were possible in California. Notwithstanding the fact that the Bank had participated in no fraud whatsoever (as is decidedly not the case of Imperial Paper and Color Corporation here), the Supreme Court affirmed a judgment against the Bank in the sum of $10,000 for conversion.

In the early case of *Moisant v. McPhee,* 92 Cal. 76, the Supreme Court passed directly on the question of an equitable lien on personal property. One McPhee held a deed absolute to a certain tract of land in Mendocino County, which deed, however, was given only for the purpose of securing an indebtedness owed to McPhee and his partner and which was held by the court to be a mortgage on real property. While this mortgage was in force and effect, McPhee and his partner entered into an agreement with Warren, whereby Warren was to peel bark on the mortgaged property, dispose of the same, and apply the net proceeds on the balance of the mortgage indebtedness held by McPhee. A quantity of bark was removed in the summer of 1886 and the proceeds applied as agreed. In the summer of 1887, Warren peeled and prepared another quantity of bark on the mortgaged land. McPhee furnished Warren with supplies and money to meet his expenses in connection with the work, which advances amounted to the sum of approximately $1,000. After the bark was peeled, piled and sheltered by Warren, Warren sold it to the plaintiff Moisant for the sum of $1404.00 and executed a

Bill of Sale to Moisant. Moisant put a man in charge of the bark and posted notices on it that he was the owner. Warren, however, had not paid his indebtedness to McPhee for the advances made by McPhee in the sum of $1,000 and McPhee seized the peeled bark, shipped it to San Francisco and converted it to his own use. Moisant obtained judgment for conversion in the lower court, and on appeal, the Supreme Court of California said:

> "The only question is, did appellant acquire a valid lien upon the bark after it was severed from the trees? We are unable to see under what statute or rule of law it can be said that he did. A lien is created by contract, or by operation of law. (Civil Code, §2881.) Appellant was not a mortgagee or pledgee of the bark, and the evidence fails to show that any contract was made which would create a lien of any kind. *But if it be admitted that he had a lien, still, the possession of the bark was not taken by him, and hence his lien was void as against the plaintiff who purchased the property in good faith and for value.*" (Civil Code, §3440.) (Italics ours.)

In *Ferguson v. Murphy,* 117 Cal. 134, an unrecorded lease which purported to give a landlord a lien for rent on a crop, raised on his property by a tenant, was annulled by the Supreme Court, in litigation between the landlord and a creditor of the tenant who had attached the crop, in the following language:

> "It was held, in effect, that the lease and accompanying agreement must be construed as intended to give security to the landlord for payment of the cash rental, and to create a lien upon the growing crop,

as such security, without complying with the chattel mortgage law, but that they were ineffectual for that purpose, and the plaintiff could not recover. It is objected that that case differs from this, because there the agreement was in parol, while here it is in writing. We see no material difference between the two agreements in this respect. An oral lease of real property for a term not exceeding one year is just as operative and binding as a written lease, and in such case, an oral agreement, like that in controversy, would be as effective as it would be if in writing. In each case the invalidity of the lien which the plaintiff claimed to have acquired and to have a right to enforce, arose from the fact that the agreement relied upon was simply an attempt to obtain the advantages of a chattel mortgage without complying with the provisions of the statute upon that subject."

In *Smitton v. McCullough*, 182 Cal. 530, the Court said (page 538):

"The policy of the law is against upholding secret liens and charges to the injury of innocent subsequent purchasers and encumbrancers. (Palmer v. Howard, 72 Cal. 293; Ruggles v. Cannedy, 127 Cal. 290; Ferguson v. Murphy, 117 Cal. 134.) The intervenor having given notice to the holder of the fund must, under the decisions in this state, be held, as against plaintiff, a bona fide encumbrancer for value, and the trial court therefore did not err in holding plaintiff's claim of lien inferior to that of intervenor."

Most of the foregoing citations relate to secret liens where an attempt was made to obtain them by means of a chattel mortgage.

In the case at bar it would have been absolutely impossible for the Imperial Paper and Color Corporation to have obtained a valid chattel mortgage on the stock in trade of the Downey Wallpaper & Paint Co., as that is one class of mortgage that is not "allowed by law" under the provisions of §3440 of the Civil Code.

Section 2955 of the Civil Code provides:

> "Mortgages may be made upon all growing crops, including grapes and fruits, and upon any and all kinds of personal property except the following: * * * (3) The stock in trade of a merchant."

Yet, notwithstanding the fact that the statute law of California expressly refuses to recognize a chattel mortgage duly executed, acknowledged, and recorded, but purporting to cover a stock in trade, even though its existence might be known to the whole world, the Imperial Paper and Color Corporation here asserts its right to a secret, undisclosed equitable lien on the Downey Wallpaper & Paint Co. stock in trade, the purported existence of which comes to light only after the stock had been seized by the trustee in bankruptcy of Downey as a creditor of the Downey Wallpaper & Paint Co.

Under the provisions of §3440 of the Civil Code of California no distinction whatsoever is made between purchasers, encumbrancers in good faith, and creditors.

The statute expressly provides that transfers or liens, where personal property is concerned, with certain exceptions not material here, are conclusively presumed to be fraudulent and void against those who are lienor's creditors while he remains in possession, and the successors in interest of such creditors, and against any person on whom his estate devolves in trust for the benefit of others than himself.

Section 3430 of the Civil Code contains one definition of creditor as:

> " 'Creditor' within the meaning of this title is one in whose favor an obligation exists, by reason of which he is, or may become, entitled to the payment of money."

Section 3439-01 of the Civil Code defines "creditor" as:

> "A person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed, or contingent."

It certainly will not be contended that the Standard Coated Products Corporation was not a creditor of Downey's family corporation at all times subsequent to the fraudulent transfer.

In *Brainard v. Cohn*, 8 Fed. (2d) 13, 7 Am. B. R. (N. S.) 10, the Circuit Court of Appeals for the Ninth Circuit stated a salutary rule:

> "It is also an established rule that, where two or more persons are associated for the same illegal

purpose, all engaged in the alleged fraudulent common purpose are as one who has received the property, and each joint tort feasor has the burden of bearing the entire loss which he in cooperation with his fellows has inflicted. Bigelow v. Old Dominion Copper Co., 225 U. S. 111. It follows that remedy may be had against all the tort feasors, or any one of them, subject to the rule that satisfaction once obtained is a bar to further action. The Beaconsfield, 158 U. S. 303. The extent of the remedy may be for the recovery of all the property *or its full value.*" (Italics ours.)

In *Buffum v. Barceloux,* 289 U. S. 227, 22 Am. B. R. (N. S.) 596, this Court said:

"The repurchase of the certificates by the fraudulent grantee during the pendency of the suit did not make it error for a court of equity to render judgment for the value. * * *

By common consent the suit was tried as one in equity, the fraudulent transferee being held to account as a trustee *ex maleficio* for the value of the shares which it had fraudulently acquired and then conveyed to someone else. United States v. Dunn, 268 U. S. 121; Independent Coal & Coke Co. v. United States, 274 U. S. 640; Newton v. Porter, 69 N. Y. 133; Hamilton National Bank v. Halsted, 134 N. Y. 520. A like recovery would have been permitted if the suit had been at law.

The defendant being chargeable with the value upon the filing of the bill, the question for us now

is whether it could change its liability by buying back the shares. The answer is supplied by the opinion of Story, J., in Oliver v. Piatt, 3 How. 333, 11 L. Ed. 622, a landmark in the law of trusts. The trustee who misapplies the subject matter of a trust becomes accountable at once for the proceeds or the value. Cf. Hamilton National Bank v. Halsted, *supra.*"

It is well settled that the validity of liens is dependent upon the law of the State in which the lien has been attempted to be created.

Straton v. New, 283 U. S. 318;

Standard Oil Co. of New York v. Stevens, 103 Vt. 1, 151 Atl. 507;

Reese, Inc. v. United States, 75 Fed. (2d) 9, 27 Am. B. R. (N. S.) 334 (C. C. A. 5th Cir.);

Eggleston v. Birmingham Publishing Co., 15 Fed. (2d) 529, 8 Am. B. R. (N. S.) 714 (C. C. A. 5th Cir.);

In Re McAllister, 7 Fed. (2d) 9, 6 Am. B. R. (N. S.) 293 (C. C. A. 2nd Cir.);

Remington on Bankruptcy, 4th Ed., §1891.

We respectfully submit that the respondent's equitable lien theory, on which the Circuit Court of Appeals allowed priority, fails completely, in the face of the settled policy of the legislature and the courts of California against secret liens, particularly on personal property.

Bank of America National Trust & Savings Association v. Sampsell, supra.

The Imperial Paper and Color Corporation Had a Full and Complete Remedy Under Which It Would Have Shared Equally With the Trustee in the Assets of the Downey Wallpaper & Paint Co., But Only Equally.

When the Order of April 7, 1939, avoiding the fraudulent transfer of Downey's stock in trade was entered by Referee Dickson and the trustee, acting under that Order, sold and disposed of the property in dispute, the Imperial Paper and Color Corporation as the only existing unpaid creditor of the Downey Wallpaper & Paint Co., [Tr. p. 17] could have filed a one creditor involuntary petition in bankruptcy against Downey's family corporation under the provisions of §59-d of the Bankruptcy Act (11 USCA, §95-d). The act of bankruptcy would have been that Mr. Sampsell as trustee in bankruptcy for Downey, as a creditor of the Downey Wallpaper & Paint Co., had obtained a voidable preference.

Upon adjudication of the Downey Wallpaper & Paint Co., as a bankrupt, the Imperial Paper and Color Corporation would have then been a creditor of its bankrupt estate in the sum claimed here, $5,415.95, and the trustee in bankruptcy of Downey, a creditor, by reason of the fraudulent transfer of Downey's assets, in the sum of $14,194.72. In that event the assets of the Downey Wallpaper & Paint Co. would have been shared pro rata between the two creditors. However, the Imperial Paper and Color Corporation permitted the four months within which it had a right to file an involuntary petition in bankruptcy against the Downey Wallpaper & Paint Co., to elapse, permitted the avoidance by the trustee to stand, and now, if the judgment of the Circuit Court of Appeals stands, it will be paid in full.

Erroneous Conception of Facts in Opinion of Circuit Court of Appeals.

At the time of the argument of this case before the Circuit Court of Appeals, the Findings of Fact, Conclusions of Law, and Order Quieting Title to Assets entered by the Referee on April 7, 1939 [Tr. pp. 102 to 117, incl.], which had been a part of the record on review before the District Court, but through error had not been printed in the transcript of record sent to the Circuit Court of Appeals, although attached to the Referee's Certificate on Review [see Subdv. 6 of Referee's Certificate on Review, Tr. p. 26], was by order of the Circuit Court of Appeals sent up and made a part of the record, and is a part of the record here. This order was made at the time of the oral argument. Thereafter, while the cause was under submission, the Circuit Court of Appeals ordered additional portions of the Downey bankruptcy record, consisting of Downey's Schedules and the Proofs of Debt of both the Imperial Paper and Color Corporation and the Standard Coated Products Corporation, to be certified up. [Tr. p. 118.]

We raise no objection to this procedure, as it was clearly the commendable desire of the Circuit Court of Appeals to get all the facts possible before it, before rendering its decision, even though counsel might not have, at the inception of the appeal, deemed it necessary to bring up such records. Unfortunately, however, there was no further oral argument subsequent to the certifying up of these additional portions of the record and the Circuit Court of Appeals, without the benefit of further oral argument, fell into error with regard to established and uncontradicted facts, which error is apparent in its opinion, and which we believe misled the Court in the final determination of the case.

We wish to point out a number of these erroneous statements of fact and the respect in which they are erroneous.

1. The Opinion says [Tr. pp. 203, 204]:

> "We assume—there being no evidence to the contrary—that the shares were issued and paid for as the bankrupt's attorney had told appellant they would be." [Opinion Circuit Court of Appeals, Tr. pp. 203, 204.]

The Evidence [Tr. p. 59]:

> "The Referee: How much cash, if any, was paid when you transferred your $14,000 worth of assets to this new corporation?
>
> The Witness: We subscribed $500.00 for the stock.
>
> The Referee: Was that actually paid in money?
>
> The Witness: Yes, in money, Your Honor."

The Referee's findings in the Order Avoiding the Fraudulent Transfer from Downey to the Downey Wallpaper & Paint Co.

Finding XIII [Tr. p. 111]:

> "That on or about the 15th day of June, 1938, the Standard Coated Products Corporation began pressing said bankrupt, Wilbur J. Downey, for payment of the obligation owing to it by said bankrupt, and thereafter, on June 30, 1938, at a time when said Standard Coated Products Corporation was vigorously demanding payment of said obligation, said bankrupt, notwithstanding the fact that the obligation held by him against the Downey Wallpaper & Paint Co., constituted the larger part of his assets, and while hopelessly insolvent, for the purpose of

hindering, delaying, or defrauding his creditors, and particularly the Standard Coated Products Corporation, without notice to it, caused the Downey Wall paper & Paint Co., to issue to him 99 shares of the capital stock of said Downey Wallpaper & Paint Co., in satisfaction in full of said obligation; that at the time of the issuance of said shares of stock to the said bankrupt there was outstanding a Permit from the Corporation Commissioner of the State of California authorizing the issuance of the shares of the capital stock of the Downey Wallpaper & Paint Co. only for cash; that said Permit was the only Permit to issue said shares in existence at said time; that notwithstanding the plain terms and provisions of said Permit, said Downey Wallpaper & Paint Co., and its officers and directors, proceeded to and did issue to the said Wilbur J. Downey, on June 30, 1938, 99 shares of the capital stock of said corporation, and that on the following day, July 1, 1938, said bankrupt caused 49 shares of said stock to be transferred to the respondent, Mildred Downey, and 25 shares of said stock to his son, David Downey, entirely without consideration."

2. The Opinion says [Tr. p. 204]:

"Thus we assume that 50 shares were issued to and paid for by each of the incorporators. The bankrupt apparently did not retain all of his 50 shares."

The Referee's Finding XIII [Tr. p. 111] hereinbefore set out expressly found that 99 shares of the capital stock were issued to Downey on June 30, 1938, and transferred by him, to a great extent, to his wife and son the following day, July 1, 1938, without consideration, and that 50 shares of stock were not issued to and paid for by

each of the incorporators. The testimony of the witness Downey in this proceeding [Tr. p. 59] expressly states that the incorporators subscribed $500.00 for the stock which, at par value of $100.00 per share would account for only five shares of stock instead of fifty, as found by the Circuit Court of Appeals.

In Finding XIV the Referee found [Tr. p. 112]:

"The Referee finds that said issuance of said 99 shares of stock, as described in the preceding finding, in satisfaction of the obligation owing to the bankrupt by said Downey Wallpaper & Paint Co. was brought about by the bankrupt and the other respondents herein for the purpose of preventing the Standard Coated Products Corporation from levying writs of attachment, garnishment, or execution upon said obligation in the enforcement of its claim against the bankrupt, Wilbur J. Downey, and that the further transfer by the bankrupt, Wilbur J. Downey, of the 25 shares of the capital stock so issued to his son, David Downey, and the 49 shares to his wife, Mildred Downey, was accomplished for the purpose of further placing beyond the reach of said Standard Coated Products Corporation any beneficial interest in said obligation owing said bankrupt by the Downey Wallpaper & Paint Co. of which it might avail itself in the collection of its indebtedness owing to it by said bankrupt."

In Finding XV [Tr. p. 113] the Referee found:

"That in accomplishing the issuance of said 99 shares of stock to said respondents no cash whatsoever was paid therefor, but a fictitious cash consideration was created by means of an exchange of checks between the bankrupt, Wilbur J. Downey, and the Downey Wallpaper & Paint Co., which ex-

change of checks occurred simultaneously and at a time when neither of the makers of said checks had sufficient funds in their respective bank accounts to have paid said checks, or either of them, except for the exchange thereof."

3. The Opinion says [Tr. p. 204]:

"It is clear, however, that the bankrupt never owned more than one-third of the corporation's stock, and at the time of the filing of the petition, may have owned as little as one-thirtieth."

The Referee's Finding XIII, in connection with the Order Avoiding the Fraudulent Transfer, finds that 99 additional shares of the capital stock of the corporation were issued by it to the bankrupt on June 30, 1938, and that on July 1, 1938, the bankrupt transferred 49 shares of it to his wife and 25 shares to his son, entirely without consideration, and in paragraphs XIII and XIV he finds that the sole consideration for the issuance of these additional 99 shares to Downey was the satisfaction of the balance due on the promissory note given by the corporation to Downey, and that the subsequent transfer of these shares to Downey's wife and son, without consideration was made with the intent to further place the beneficial interest therein beyond the reach of the bankrupt's creditors. The reason that the bankrupt, at the time of the filing of the petition "may have owned as little as 1/30th" of the capital stock of the corporation was that he had theretofore fraudulently conveyed all except the few shares listed in his schedules, to his wife and son.

4. The Opinion says [Tr. p. 204]:

> "On July 21, 1936, the bankrupt * * * recorded in the office of the County Recorder a notice of the intended sale of his then existing stock of wallpaper and paints to the corporation. The notice stated that the sale would be made on July 28, 1936, for a consideration of $7500.00, represented by the corporation's promissory note payable six months from that date. *The sale was made pursuant to the notice.*" (Italics ours.)

The Evidence [Tr. p. 53]:

Trustee's Exhibit No. 2, the letter written by Major Hutton, the bankrupt's attorney, to the petitioner, Imperial Paper and Color Corporation [Tr. p. 53], expressly states that:

> "The stock of wallpaper and paint will be purchased by the new company from W. J. Downey *at inventory.*" (Italics ours.)

It is therefore clear that the Circuit Court of Appeals was under a misconception as to the amount of the promissory note taken by Downey from the corporation, which actually was in the sum of $14,194.72 instead of $7500.00 as the Circuit Court of Appeals assumed.

The vice of this erroneous conception will be apparent in the sixth error of fact which we shall presently point out.

5. The Opinion says [Tr. p. 205]:

> "At the time of the sale by the bankrupt to the corporation—July 28, 1936—Standard was the bankrupt's only creditor. At that time the contract of April 1, 1933, between Standard and the bankrupt

was still in force. Thereby the bankrupt was required to, *and presumably he did,* pay over to Standard or its assignee, for application on his notes, all money realized from the sale made by him to the corporation on July 28, 1936." (Italics ours.)

The Evidence [Tr. p. 111]:

It was definitely established at the trial of the fraudulent conveyance issue that Downey did not pay over to the Standard or its assignee for application on its note all the money realized from the sale made by him to the corporation on July 28, 1936, but on the contrary, utilized a $9900.00 unpaid balance on the note given him by his corporation to "purchase" 99 shares of the capital stock of the corporation to be issued directly to him. The day after these shares were issued to him he transferred most of this newly issued stock to his wife and son. Thus instead of the bankrupt paying over to the Standard the purchase price of this stock in trade he suddenly utilized almost two-thirds of the unpaid balance to cause stock in the corporation to be issued to himself and promptly transferred it to his wife and son, thus keeping it in the family. [See Referee's Findings XIII and XIV, Tr. pp. 111, 112.]

When the Circuit Court of Appeals examined the Schedules filed by Downey in his bankruptcy proceeding, certified up as an additional part of the record, naturally it did not find scheduled any balance due on this note for $14,194.72, by reason of the fact that on June 30, 1938 [Referee's Finding XIII, Tr. p. 112], Downey had cancelled the note in exchange for the 99 shares of stock issued to him. Neither did the Circuit Court of Appeals find in Downey's Schedules, a listing of the 99 shares of

stock, as the bankrupt had transferred 74 shares of it to his wife and son on July 1, 1938, entirely without consideration. [See Referee's Findings XIII and XIV, Tr. p. 112.]

The Circuit Court of Appeals was therefore led to the conclusion that the Standard Coated Products Corporation had received the entire purchase price of this stock in trade and was not defrauded, whereas, in truth and in fact only $5,000 was ever paid on this promissory note, outside of the issuance of the 99 shares of stock to Downey.

See Transcript of Testimony of Wilbur J. Downey, page 42, as follows:

"Q. You took a promissory note? A. Yes.

Q. And that was never paid? A. $5,000 was paid, in cash."

6. The Opinion says [Tr. p. 205]:

"The bankrupt received in consideration of the sale, the corporation's note for *$7500.00* of which it is conceded $5,000 was paid. The bankrupt testified before the Referee that the balance ($2500.00) was not paid." (Italics ours.)

It is in this statement that the vice of the misconception of the Circuit Court of Appeals as to the amount of the promissory note taken by Downey, is evident. The Court overlooked the fact that the amount of the promissory note was $14,194.72 [Tr. p. 107] and that with a $5,000 payment having been made in cash (according to Downey's testimony) there was actually a balance due, without

interest, amounting to $9,192.72 instead of only $2500.00 as the Circuit Court of Appeals assumed, for which 99 shares of capital stock were issued to Downey on June 30, 1938.

The bankrupt testified in this proceeding [Tr. p. 42]:

"Mr. Tobin: Q. After you organized the corporation you transferred all of your stock—all of your own stock to it, did you not? A. No, a great part of it, yes.

Q. $14,000 worth? A. Yes.

Q. And you did it on credit? A. Yes.

Q. You took a promissory note? A. Yes.

Q. And that was never paid? A. $5,000 was paid, in cash."

Further along in his testimony [Tr. p. 59] Downey testified as follows:

"The Referee: How much did you get in payment at the time of the transfer?

The Witness: Nothing, Your Honor, the corporation wrote a note, subsequently, we paid $5,000 cash against that note."

In Finding XIII [Tr. pp. 111, 112] the Referee found that the bankrupt caused the Downey Wallpaper & Paint Co. to issue to him 99 more shares of the capital stock of the Downey Wallpaper & Paint Co., in satisfaction in full of said obligation, which was thereafter, the next day, transferred to his wife and son without consideration. [Tr. p. 112.] Thus, by no stretch of the imagination could the Standard Coated Products have received the balance of the purchase price of said stock in trade.

Yet,

7. The Opinion says [Tr. pp. 205, 206]:

"Therefore, we think it may reasonably be inferred that the corporation's note for *$7500.00 was fully paid, and that Standard or its assignee received the full amount thereof.*" (Italics ours.)

Without repetition, we believe that this erroneous conception of fact has been fully covered in the preceding discussions.

8. The Opinion says [Tr. p. 206]:

"Standard and its assignee were fully advised of the sale by the bankrupt to the corporation. Neither of them objected nor complained."

The Evidence:

Downey testified differently [Tr. pp. 45, 46] as follows:

"Q. You say there was no idea in your mind at that time to form a new corporation? A. The meaning of that is, I had no idea of forming a corporation when I was in Glenns Falls.

Q. And the suggestion came from the Imperial Paper and Color Corporation? (Mr. McBride, President.) (Parenthetical matter ours.) A. Yes.

Q. Well, we are only interested in the corporation itself. Read the question. (Question read.)

Q. The question is this: Did you tell him that you would do that, if you were unable to get the indebtedness reduced? A. Not at that time, no.

Q. When did you do that? A. By correspondence, *after I received this refusal on the part of the Standard Company.*" (Italics ours.)

The objection of the Standard Coated Products Corporation to this interesting arrangement is likewise evidenced by the language used in Trustee's Exhibit No. I, Attorney Frank S. Hutton's letter to the Imperial Paper and Color Corporation dated June 17, 1936, in which he states [Tr. p. 51]:

> "Mr. Downey's plan of reorganization was turned down by the Standard."

And his statement in Trustee's Exhibit No. 2 [Tr. p. 54] that:

> "The only entity that could possibly take exception to this new transaction is the Standard Company, but if any exception is taken to it, it simply means that they will be biting off their nose to spite their face, and the psychology is all in favor of a successful conclusion."

At page 58 of the Transcript Downey testified, in response to his counsel's questions, as follows:

> "Q. And was anything done by any one on your behalf to conceal the fact that you intended to form the corporation? A. No, not at all. I wrote to the Standard Company very frankly and told them.
> * * *
>
> Q. In other words, you wrote a letter to the Standard Textile Company informing them of your plan? A. Yes.
>
> Q. That was before the corporation was formed? A. *After it was formed, Mr. Casey.*" (Italics ours.)

At page 63 of the Transcript, he testified:

> "Q. And isn't it a fact that at the time you advised the Standard Company of the formation of this corporation, that they refused to accept this proposi-

tion? A. *Yes, because of their own internal trouble.*" (Italics ours.)

In the proceeding to avoid the fraudulent transfer the Referee found in Finding VI [Tr. pp. 106, 107]:

> "* * * That without the knowledge or consent of said Standard Coated Products Corporation, a corporation, and while heavily indebted to it, as aforesaid, said bankrupt, Wilbur J. Downey, after causing to be organized under the laws of the State of California said respondent Downey Wallpaper & Paint Co., caused all of the capital stock therein to be issued to himself, his wife, the respondent Mildred Downey, and to his son, respondent David Downey, and caused himself, his wife Mildred Downey and his son David Downey to be elected as directors of said Downey Wallpaper & Paint Co., and thereafter to be elected president, vice-president and secretary-treasurer, respectively."

And four days later he made the deal to transfer his assets to it. [Finding VII, Tr. p. 107.]

9. The Opinion says [Tr. p. 206]:

> "Instead, with full knowledge of the sale, Standard and its assignee extended further credit to the bankrupt to the amount of more than $5,000."

This statement is apparently based upon the fact that proofs of debt filed by the Standard in the Downey bankruptcy proceeding indicate that merchandise had been sold to him on credit or on consignment, subsequent to the sale

by the bankrupt of his stock in trade on July 28, 1936. Even though this might be true there is nothing in the record that indicates *when* Downey conveyed the information to the Standard that he had formed this corporation and that he had transferred a $14,000 stock to it.

It will be noted that the Contract, Exhibit "A", between Downey and the Standard Textile Company which was attached to the proof of debt for $104,000, which is found in the Transcript at page 179, and which Contract was relied upon by the Circuit Court of Appeals in drawing the inference that because it provided for payment to the Standard of the proceeds of Downey's sales of stock, that that was actually done, expressly provides [Tr. p. 190]:

> "Party of the first part does hereby agree to provide party of the second part with a *consigned* stock of its products which shall be sufficient to enable second party to properly carry on his business as a Distributor for first party, party of the first part to be the sole judge as to the amount of such consigned stock which shall be sufficient to carry on said business in accordance herewith." (Italics ours.)

We may therefore well assume that the amount of "credit" which the Circuit Court of Appeals found was extended to the bankrupt in an amount of more than $5,000, consisted of sales of merchandise on consignment, which had not been accounted for.

Furthermore, in the Findings in connection with the Order Avoiding the Fraudulent Transfer, the Referee found [Finding VI, Tr. p. 106] that, contrary to the

Standard not objecting or complaining of the transfer, there was, at the date of the adjudication of the bankrupt as a bankrupt, in the Superior Court of the State of California, in and for the County of Los Angeles, a suit pending, in the nature of a Creditors' Bill, brought by the Standard Coated Products Corporation, for the purpose of determining the question of *alter ego* existing between the Downey Wallpaper & Paint Co. and the bankrupt. This suit was naturally halted by reason of the bankruptcy of Downey, and the corporation having turned over its assets to the receiver and trustee in bankruptcy of Downey's estate, by stipulation. [See Finding IV, Tr. p. 105.]

10. The Opinion says [Tr. p. 209]:

> "In the case at bar, Appellee did not allege or ask the Referee to hold that the corporation was the bankrupt's *alter ego*, nor did the facts warrant such a holding. For the bankrupt did not own all or even a majority of the corporation's stock. The evidence is that he owned less than one-fifth of it."

The inaccuracy of this statement is evident on examination of the Referee's Finding of Fact XIII [Tr. pp. 111, 112] that 99 additional shares of the capital stock of the corporation were issued by it to the bankrupt on July 30, 1938, and on the next day 49 shares were transferred by him to his wife and 25 shares to his son, entirely without consideration to him.

If this last fraudulent transfer had not taken place the bankrupt, at the date of bankruptcy, would have owned two-thirds or more of the capital stock and the balance

would have been held by his wife and son. In either case the rights of the Standard Coated Products Corporation were placed entirely at the mercy of the bankrupt Downey and his immediate family. In fact, Downey admitted [Tr. p. 42] that he still owed the greater part of the indebtedness to the Standard Coated Products Corporation, and that after the transfer of his $14,000 stock in trade to his family corporation he had nothing but five shares of its stock in his own name out of which the Standard Coated Products could collect that claim. [Tr. p. 42.]

It is also significant that the merchandise taken over by the trustee from the Downey Wallpaper & Paint Co. did not consist entirely of wallpaper purchased from the Imperial Paper and Color Corporation. A part of it was paint which had been bought from a dozen different concerns. [See redirect examination of Downey, Tr. pp. 61, 62.]

No effort was made on the part of the Imperial Paper and Color Corporation to establish an equitable lien on the stock in trade of the Downey Wallpaper & Paint Co., or to show what portion of its stock was wallpaper and what portion was paint, yet the trustee is required by the order of the Circuit Court of Appeals to pay the sum of $5,415.95 principal out of the proceeds derived by him from the sale of the Downey Wallpaper & Paint Co., stock, which consisted in part of paints purchased from a dozen different companies and which had been paid for.

Trustee's Rights Under State Law and Under the Bankruptcy Act.

At the time of the fraudulent transfer by the bankrupt of this $14,194.72 worth of merchandise to his family corporation on July 28, 1936, Section 3439 of the Civil Code of California which we have heretofore quoted verbatim, made transfers of property with intent to hinder, delay or defraud any creditor of a debtor, void as against all creditors of a debtor, their successors in interest, and against any person upon whom the estate of the debtor devolves in trust for the benefit of others than himself. The onus of the omission to take earlier steps to avoid this fraudulent transfer seems, by the Circuit Court of Appeals in its Opinion, to have been placed upon the Standard Coated Products Corporation, the bankrupt's largest creditor. However, the trustee was not restricted entirely to the rights of the Standard Coated Products Corporation, although it really was the creditor which Downey actually intended to defraud.

The Circuit Court of Appeals apparently overlooked the fact that there were other creditors of the bankrupt who had provable claims on file and as to whom this transfer likewise acted as a fraud under the provisions of Sec. 3439 of the Civil Code of California.

The record shows the claims of Blake, Moffitt & Towne, $25.89 [Tr. p. 143]; Price, Waterhouse & Co., $450.00 [Tr. p. 139]; Dun & Bradstreet, Inc., $59.33 [Tr. p. 157]; Howard Automobile Company of Los Angeles $41.53 [Tr. p. 170], together with various tax claims against the bankrupt.

Under the provisions of Sec. 3439 this transfer was void as against *all* creditors of the debtor, and not merely

those existing as of the date of the transfer. (Italics ours.)

Bush v. Mallett v. Helbing, 134 Cal. 676;

Horn v. The Volcano Water Co., 13 Cal. 62, at p. 72;

Cardenas v. Miller, 108 Cal. 250.

Noyes v. Bank of Italy, 206 Cal. 266, at 271, where the Court said:

> "The term 'creditors' is general and applies to creditors existing prior to the mortgage as well as subsequent."

And the trustee or the creditors entitled to attack a fraudulent conveyance are not restricted to the sometimes empty remedy of attempting to set it aside. Even if the property is available but has depreciated in value during the time it was in the possession of the fraudulent transferee, or if it has been sold or disposed of, creditors or the trustee have a right to recover its highest market value during the interim, from the fraudulent transferee as a trustee *ex maleficio.*

See:

Buffum v. Barceloux, 289 U. S. 227.

At the hearing in the case at bar it developed that although the fraudulent transferee Downey Wallpaper & Paint Co. had, as might be expected in the case of a merchant engaged in trade, disposed of the identical articles fraudulently transferred to it by Downey in July, 1936, it still, however, had on hand a substantial stock of merchandise which was subject to being levied upon and sold

under execution. This property or stock in trade was in the actual and physical possession of the trustee, having been turned over to him by the fraudulent transferee, and it was therefore subject to the summary jurisdiction of the Referee.

Murphy v. John Hoffman Co., 211 U. S. 562, 21 Am. B. R. 487;

Whitney v. Wenman, 198 U. S. 539, 14 Am. B. R. 45;

White v. Schloerb, 178 U. S. 542, 4 Am. B. R. 178;

Babbitt v. Dutcher, 216 U. S. 102, 23 Am. B. R. 519;

Hebert v. Crawford, 228 U. S. 204, 30 Am. B. R. 24;

Taubel-Scott-Kitzmiller Co. v. Fox, 264 U. S. 426, 2 Am. B. R. (N. S.) 912;

Isaacs v. Hobbs Tie & Timber Co., 282 U. S. 734, 17 Am. B. R. (N. S.) 273.

And there is no question but that title to all of the property in the possession of the Downey Wallpaper & Paint Co. was vested in that corporation, subject of course, to being defeated by virtue of a judgment in favor of a defrauded creditor, or any person as to whom it, or any part of it had been transferred in fraud of creditors; and likewise was subject to being levied upon and sold under judicial process by any creditor obtaining a judgment against this corporation. (Bankruptcy Act, Sec. 70A and E.)

Instead of going through the circuitous procedure of having the Referee render an order finding that Downey

had fraudulently transferred $14,000 or more of his stock to the Downey Wallpaper & Paint Co. three years before and that the identical articles of merchandise so transferred had been sold and disposed of and were no longer in his possession and that the trustee would be entitled to a money judgment in the sum of $14,194.72, under which judgment he would be entitled to a writ of execution, which a Referee is powerless to issue, and then requiring the trustee to go on either the law side of the United States District Court or to the Superior Court of the State of California, in and for the County of Los Angeles, pleading *res adjudicata* and asking for a money judgment and execution, to be levied upon the stock in trade which was even then in the actual, physical possession of the bankruptcy court, the Referee simply exercised his equitable powers, and it not being asserted that the merchandise in the trustee's possession was in excess of the sum of $14,194.72, the Referee simply marshalled those assets into the bankrupt estate, decreed the trustee to be the owner of them and ordered them sold in the usual course of procedure under the Bankruptcy Act.

Let us suppose, on the other hand, that the more circuitous procedure had been followed and a money judgment for the value of the fraudulently transferred property had been obtained by the trustee and the property levied upon under writ of execution, could the Imperial Paper and Color Corporation, a simple contract creditor of the fraudulent transferee, have come into any court in California and asserted an equitable lien on the personal property, or a right to be paid in full on its claim on open account, before the sheriff would be permitted to sell the property at execution sale? Certainly not. And we do not believe that because the Referee exercised his equitable powers in the interests of expedition and to avoid

circuity of action, that this claimant, at whose suggestion the fraud originated, should be placed in a position even higher than it would have been placed had it filed an involuntary petition in bankruptcy against the Downey Wallpaper & Paint Co., within four months after the entry of the order of Referee Dickson on April 7, 1939, decreeing the transfer to have been actually fraudulent and marshalling the transferee's stock in trade into the bankrupt estate.

Neither do we know of any type of proceeding which could be instituted in any court by the Imperial Paper and Color Corporation, after a decree as between the actual parties to the fraudulent conveyance proceeding had become final; wherein it, as a creditor of the fraudulent transferee, could collaterally attack that decree. In fact, in the case at bar no attempt was made to do so. There is no contention here on the part of the Imperial Paper and Color Corporation that this decree or order of the Referee was made through collusion on the part of the trustee and the Downey Wallpaper & Paint Co. On the contrary, the Imperial people, recognizing said order, as constituting the trustee's muniment of title to the personal property in question, pleaded it affirmatively in its petition in paragraph III [Tr. p. 15], in the following language:

> "That the above entitled bankrupt estate and the trustee thereof, claims and asserts that the Downey Wallpaper and Paint Co., a corporation, is and was the *alter ego* of the above named bankrupt, and that the trustee herein has procured an order of court to that effect, and that the said trustee herein has taken possession of the property and assets of the Downey Wallpaper & Paint Co. and has sold and disposed of the same, and claims a right to administer and distribute the said assets."

Had the Imperial Paper alleged in its petition that the Referee's order avoiding the fraudulent transfer had been fraudulently obtained by the trustee, or was improper in any manner, then we would have gone ahead and retried the entire fraudulent conveyance proceeding with the Imperial Paper as a party, but that order having been recognized by the Imperial Paper and Color Corporation, we merely went forward from that point and proved the Imperial's connection with the fraud theretofore established.

Conclusion.

We respectfully submit that the Circuit Court of Appeals for the Ninth Circuit fell into error, partly through a misconception of facts, error, which if permitted to stand, will not only work a gross injustice in the instant case, but will establish a dangerous precedent in the law.

It is very clear that this is a case in many ways similar to that of *Buffum v. Barceloux,* 289 U. S. 227, in which this Court granted certiorari and later reversed the judgment of the Circuit Court.

In the case at bar the bankrupt Downey had involved himself to the extent of $108,000 with the Standard Coated Products Corporation and it was giving him a chance to slowly work out. He apparently decided to put in the line of a competitor, the Imperial Paper and Color Corporation, and it was desirous of selling him. He was also desirous of retaining for his own benefit the $14,000 stock in trade, which the Standard Coated Products Corporation was permitting him to retain, and deal with in an effort to work himself out of the large indebtedness owing to it. The Imperial people, however, were afraid to sell Downey on credit by reason of the constant menace

of the indebtedness owing to the Standard Coated Products Corporation. Its president, Mr. McBride, therefore suggested to Downey that he either "chisel" the Standard Coated Products into reducing its claim against Downey to what the Imperial regarded as a decent compromise figure, or that Downey go through bankruptcy, or that he form a a corporation. In the event Downey went tnrough bankruptcy, the $14,000 stock would have been available to his creditor, the Standard Coated Products Corporation.

Up to the time of the conference with the president of the Imperial Paper and Color Corporation no such idea as forming a corporation and transferring his assets to it, in defiance of the rights of the Standard Coated Products Corporation, had entered Downey's head. When the Standard Coated Products refused to accede to any of Downey's propositions he came back to Los Angeles and organized a corporation, entirely within his family. To quote the language of Mr. Justice Cardozo in *Buffum v. Barceloux, supra:*

> "The business was a family affair, and strangers were not welcome within the family preserve. A time arrived when the unwelcome stranger seemed likely to break in. The family combined to maintain its solidarity and keep the intruder out."

Downey then proceeded to "sell" practically his entire stock in trade to his family corporation, it amounting to in excess of $14,000. He filed a Bulk Sales Notice under the provisions of §3440 of the Civil Code, which falsely stated that he was transferring only $7500.00 worth of his stock, when in truth and in fact he was transferring over $14,000 worth. The sale was made entirely on credit, and by means of gratuitous extensions of payment on

Downey's part, final settlement of this amount was delayed from the summer of 1936 until the summer of 1939, at which latter time Downey satisfied the note in full, in exchange for 99 shares of the capital stock, most of which was immediately transferred to his wife and son, and the rest disposed of in the same manner, until at the date of bankruptcy he had only five shares left.

It is evident that the Standard people were becoming restive at the time of the issuance of this stock to Downey, so Downey intended to entangle matters still further by getting rid of the note first and then the stock, in order that the Standard people could not levy upon the balance due him from his family corporation.

Badge of fraud after badge of fraud is conspicuous in this entire transaction. Downey was clearly hopelessly insolvent at all times from the year 1936 on.

Indebtedness or insolvency of the grantor may be a badge of fraud.

Moore on Fraudulent Conveyances, §14, p. 249.

The stock in the new corporation was to be issued entirely to the bankrupt and his family, and relationship between the parties may constitute a badge of fraud.

In *Pepper v. Litton*, 60 Sup. Ct. 238, 38 Am. B. R. (N. S.) 454, this Court, speaking through Mr. Justice Douglas, quoted with apparent approval, at footnote 28, the following language of the District Court, which originally tried that flagrantly fraudulent case:

> "An examination of the facts disclosed here shows the history of a deliberate and carefully planned attempt on the part of Scott Litton and Dixie Splint Coal Company because they are in reality the same.

> In all the experience of the law, there has never been a more prolific breeder of fraud than the one-man corporation. It is a favorite device for the escape of personal liability. This case illustrates another frequent use of this fiction of corporate entity, whereby the owner of the corporation, through his complete control over it, undertakes to gather to himself all of its assets to the exclusion of its creditors."

The sale in the case at bar was made by Downey to his family corporation entirely on credit, and such a sale may likewise be considered as a badge of fraud.

Moore on Fraudulent Conveyances, §18, p. 256.

The corporation's business was carried on in the same place of business as Downey's individual business and the transfer was not accompanied by immediate delivery and actual and continued change of possession, as required by the Bulk Sales Act (Civil Code of California, §3440).

Retention of possession is likewise a badge of fraud.

Moore on Fraudulent Conveyances, §11, p. 247.

The fact that this transfer was made on credit to an irresponsible corporation, controlled by the bankrupt and his immediate family, is evidenced by testimony that, although it was made in consideration of a six months' promissory note for the purported purchase price in 1936, at the time of the trial of the proceeding to avoid it, only $5000.00 had been paid on this promissory note over a period of three years. [Tr. pp. 42 and 59.] The only capital stock in this corporation actually subscribed, amounted to the small sum of $500.00. This is a badge of fraud.

Moore on Fraudulent Conveyances, §18, p. 256.

In *Amundson v. Folsom,* 219 Fed. 122, 33 Am. B. R. 318, the Circuit Court of Appeals for the Eighth Circuit, in a fraudulent coveyance case, said:

> "It is too narrow a view to regard each step in the transaction separately and independently. It may be true as argued, that creditors of a partnership merely as such, have not a lien on partnership assets as distinguished from an equity in their administration, or that the members of an insolvent firm may lawfully sever their relation and one sell his interest in the firm property to the other, or that a debtor in failing circumstances can turn business assets into exempt property and hold it, or that one may lawfully purchase a stock of goods in bulk from another, or finally, that it is not in itself fraudulent for an insolvent debtor merely to make a preferential transfer or for his creditor to receive it. But all such things, especially when in close consecutive association, are to be considered with what else appears, in determining whether the result was the consummation of a preconceived purpose to hinder, delay or defraud creditors. As in the case of a preference (Van Iderstine v. Natl. Discount Co., 227 U. S. 575), the other acts recited are often incidents or methods of a scheme to defraud. Transactions, apparently innocent when separately regarded, may take on a different signification when seen in their true connection with others. And it is not always safe to venture a prohibited course on a mosaic of sound but unrelated rules of law."

And the California case, *Cioli v. Kenourgios,* 59 Cal. App. 690, quoting from *Bump on Fraudulent Conveyances,* says:

> "The sentiments of affection commonly generate this confidence, and often prompt relatives to provide

> for each other at the expense of just creditors. Consequently relatives are the persons with whom a secret trust is likely to exist. The same principle applies to all persons with whom the debtor has confidential relations. Any relation which gives rise to confidence, though not a badge of fraud, strengthens the presumption that may arise from other circumstances, and serves to elucidate, explain, or give color to the transaction. This doctrine applies to the relationship of father * * * brother * * * etc. Wherever this confidential relation is shown to exist, the parties are held to a fuller and stricter proof of the consideration, and of the fairness of the transaction."

We respectfully submit that we definitely and conclusively established the Imperial Paper and Color Corporation's connection with the fraudulent scheme later carried out by Downey and his immediate family, to the detriment of Downey's creditors.

Instead of having extended credit to the Downey Wallpaper & Paint Co., "in good faith" as alleged by it [Tr. p. 15], the Imperial Paper and Color Corporation had extended the credit in bad faith and as a means of assisting Downey to defraud a competitor and a creditor. This was expressly found by the Referee who saw the witnesses and had an opportunity to judge their credibility. [See Referee's Order Disallowing Imperial Paper and Color Corporation's Claim as Prior, Tr. p. 34; also see Referee's Certificate on Review, Tr. p. 24.] This finding was confirmed by the District Judge and reversed by the Circuit Court of Appeals, we believe, due partly to a misconception of the facts.

To permit this decision to stand simply means, that hereafter a trustee in bankruptcy, seeking a money judgment against a person who has obtained a fraudulent transfer from a bankrupt, under the provisions of §67-e and §70-e of the Bankruptcy Act, and if such fraudulent transferee has disposed of the property in specie before the action was commenced against him, would be obliged, after recovering his judgment, to first pay all the creditors of the fraudulent transferee in full, before he could levy on his property. This would be especially embarrassing in the case of a merchant with a shifting stock in trade, who had obtained a fraudulent transfer of merchandise from another merchant who had later gone bankrupt. All he would need to do would be to dispose of the actual merchandise fraudulently received by him, and before the trustee could levy on its replacement, the trustee would first have to go out and hunt up defendant's creditors and pay them in full.

Prior to the holding of the United States Circuit Court of Appeals in the case at bar, a trustee could bring suit against a fraudulent transferee and recover a money judgment for the value of the property so transferred. (*Bankruptcy Act*, §67-e and §70-e; *Buffum v. Barceloux, supra.*) He could then procure the levy of a writ of execution on the defendant's stock in trade, or any other assets, and sell the property at execution sale. Now he cannot do it, unless this Court reverses the judgment of the Circuit Court of Appeals. That decision would, for all practical purposes, emasculate the fraudulent conveyance provisions of the Bankruptcy Act, and we can very easily fore-

see how a vengeful or tricky and fraudulent bankrupt, in collusion with an irresponsible fellow-conspirator, could unload his assets into the hands of such irresponsible person, knowing full well that if the fraud is uncovered, the trustee, learning that the fraudulent transferee is irresponsible and has contracted a heavy indebtedness of his own, would not engage in the difficult type of litigation necessary to avoid the fraudulent transfer, by reason of the fact that, before he could avail himself of the fruits of his recovery, he must pay the fraudulent transferee's creditors in full.

The only alternative would be that if the trustee proceeded to do his duty under the Bankruptcy Act and obtained a money judgment against the fraudulent transferee, levied upon his property and sold it, he would then be inviting into the bankruptcy proceeding of the original bankrupt, a host of additional claims of creditors of the fraudulent transferee, who, under their mere assertion that they had had business transactions with the fraudulent transferee "in good faith," believed that their claims should be allowed in full as prior. Thus, the bankrupt estate would go to the heavy expense of recovering assets from fraudulent schemers, only to have the creditors of those schemers step in and walk off with the proceeds, with the estate paying the bill for their recovery.

We do not believe that this Court will permit a new class of priorities, not provided for in the Bankruptcy Act, to be engrafted thereon by judicial construction, especially in a case where the person or corporation seek-

ing the priority is the prime instigator of the scheme to defraud.

Pepper v. Litton, 60 Sup. Ct. 238.

We respectfully submit that the judgment of the Circuit Court of Appeals should be reversed, and that of the District Court and of the Referee affirmed.

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